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No. 137

# In the Supreme Court of the United States

OCTOBER TERM, 1944

PRUDENCE REALIZATION CORP., PETITIONER

*v.*

FERRIS ET AL.

*ON WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF NEW YORK*

**BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE**

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This controversy, which comes here from the Court of Appeals of the State of New York, arose in connection with the distribution of the proceeds of a mortgage under a plan for the reorganization of guaranteed mortgage participation certificates under Section 77B of the Bankruptcy Act. This plan was confirmed by the United States District Court for the Eastern District of New York in proceedings for the reorganization in bankruptcy of Amalgamated Properties, Inc., without determining the relative rights in the mortgage of certain certificates held

by the guarantor. Instead it reserved adjudication of these rights to a "court of competent jurisdiction." A proceeding was instituted in a New York state court to obtain an adjudication of this question. The Securities and Exchange Commission did not participate in the proceeding in the New York courts but believes that a statement of its views is appropriate in this Court because the implications of the decision below have an important bearing on creditors' rights in federal reorganization proceedings. This brief is accordingly submitted as *amicus curiae*.

## OPINIONS BELOW

The opinion of the Special Term of the New York Supreme Court (R. 221–222) has not been officially reported. The opinion of the Appellate Division, First Department (R. 232–233), reversing the Special Term, is reported in 266 App. Div. 543. The opinion of the New York Court of Appeals (R. 241–251), reversing the Appellate Division, is reported in 292 N. Y. 210.

## JURISDICTION

The judgment of the Supreme Court of New York pursuant to the mandate of the New York Court of Appeals was entered April 24, 1944 (R. 238–240). A petition for writ of certiorari was filed June 7, 1944, and granted October 9, 1944 (R. 252). Jurisdiction of this Court is invoked

under Section 237 (b) of the Judicial Code (28 U. S. C. 344 (b)).

## QUESTIONS PRESENTED

1. Whether federal or state law should govern the status under a Section 77B plan of reorganization of a guarantor's holding of its own guaranteed certificates relative to the rights of public holders of such certificates, where the plan has reserved that question for subsequent determination in any court of competent jurisdiction and the question has in fact been raised in a state court.

2. Whether, as a matter of federal equity as administered in bankruptcy, holdings by an insolvent guarantor of securities guaranteed by it should be subordinated to holdings of public security holders where the guarantor's holdings were acquired after default and in an effort to reduce or defer its obligations as guarantor.

## STATEMENT

In view of the full statement of facts to be expected in the briefs of petitioner and respondents, we refer only to the following facts as of particular importance to an understanding of the Commission's views:

The Prudence Company, Inc. ("Prudence"), which was engaged in the mortgage-guaranty business, sold to the public certificates of participation in a bond and mortgage made by Burnside

Improvement Company, Inc., and guaranteed to certificate holders the payment of interest thereon when due and of the principal thereof when due or within 18 months thereafter[1] (R. 12–13, 36–39). Burnside defaulted in the payment of an installment of principal due January 1932[2] (R. 90). After this default and within the 18 months' period of grace provided in the guarantee, Prudence purchased certificates aggregating $431,212.86, or approximately 42% of the $1,016,000 face amount of certificates outstanding (R. 13–14, 40–44, 220). These certificates were acquired by Prudence, the guarantor, by purchase, usually at a discount, either directly from the holder or through a concealed brokerage account, and by exchange for certificates in other issues of later maturities.[3] (R. 15–16, 40–44, 146, 149, 157–158, 220).

In 1935 Prudence went into section 77B reorganization (R. 14), and in 1938 was adjudicated insolvent (R. 16). Thereafter a plan for its reorganization was confirmed by the district court (R. 16, 49–71). The plan transferred to peti-

[1] Prudence, which had made the mortgage loan to Burnside and assigned the bond and mortgage without consideration to an affiliate (Prudence-Bonds Corporation), sold to investors certificates of participation which the affiliate had issued and, without payment of any consideration, delivered to Prudence (R. 12, 13).

[2] The entire principal matured July 1932 (R. 147).

[3] In many cases the certificate holder was given part cash and a new investment for the balance (R. 40–44).

tioner, Prudence Realization Corporation, all the assets of the defaulting guarantor (R. 16) including the reacquired Burnside certificates.

Prudence Realization Corporation is engaged in conserving and liquidating the assets it has received for the benefit of the creditors of Prudence including those holding claims on the guarantees of Prudence amounting to $122,214,000 (R. 16, 46).[4] The principal other creditor of Prudence was the R .F. C. with an unsecured claim of $11,347,775.50 (R. 66), representing the balance of a $20,000,000 loan after application of the security for the loan. Under the plan the extent of the claim of the holder of a guaranteed obligation is determined by an appraisal of the value of the property securing his claim and the deduction of that value from the face amount of the guaranteed obligation (R. 58—60, 66–69, Plan Art. IV, 2 (ii), Art. V).

Amalgamated Properties, Inc., a wholly owned subsidiary of Prudence, was caused by Prudence to take title in 1932 to the property subject to the Burnside mortgage (R. 14, 125). In March 1936 Amalgamated filed a voluntary petition for reorganization under section 77B as part of the reorganization of its parent (R. 14, 220). The two proceedings were later severed (R. 220).

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[4] Of this amount the claims arising out of guarantees by Prudence of secured bonds were $58,833,000, of mortgage participation certificates, $50,858,000, and of whole mortgages, $12,523,000 (R. 46).

Prudence filed a claim in the Amalgamated proceeding based on its holding of the Burnside certificates. Objection was made that Prudence, having defaulted on its guaranty, could not participate in the mortgage on a parity with other holders of certificates (R. 16). The Burnside plan, as ultimately confirmed (R. 96-122), did not decide the question of the participation to be granted Prudence on its interest in the bond and mortgage, but reserved this question for adjudication by a "Court of competent jurisdiction" (R. 121). Pursuant to the plan, the Burnside bond and mortgage and title to the property were assigned to Ferris, Long and Leifert, trustees appointed for the certificate holders, without merger of the mortgage and fee (R. 96, 97, 100, 101, 244).

The Amalgamated proceeding was terminated (R. 130, 245) with the question of parity not determined or reserved for determination by the bankruptcy court. Thereafter, an action was instituted in the New York Supreme Court, Special Term, by the trustees and various certificate holders against Prudence Realization Corporation to determine the rights of participation to which the certificates acquired by the insolvent guarantor were entitled (R. 171, 211). None of the parties questioned that the state court was a court of "competent jurisdiction" within the meaning of the plan. Petitioner asked summary judgment decreeing that it was entitled to parity (R. 215-

219). Summary judgment was denied (R. 221–222), petitioner appealed, and the Appellate Division reversed the order denying summary judgment and granted such judgment (R. 232–237). On appeal, the Court of Appeals of New York reversed the Appellate Division, holding that in the proceeding before it the question of parity is one of state law and that under local law the guarantor's holdings will be subordinated to the other certificates. Pursuant to the mandate of the court, judgment was entered by the Supreme Court of New York. It is this judgment which is before this Court for review.

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[redacted]

[redacted]

or subordination turned upon equitable principles governing the administration of insolvent estates, and that it is for the bankruptcy court "to define and apply federal law in determining the extent to which the inequitable conduct of a claimant in acquiring or asserting his claim in bankruptcy requires its subordination to other claims which, in other respects, are of the same class. . . . Hence the New York rule, in the absence of an actual agreement to subordinate the guarantee, is merely a general rule of law governing ordinary proceedings, it is not controlling in bankruptcy."

It would seem that the Second Court is determining that the issue involved here presents a question of federal law unless (1) the decision of the court below has not applied "merely a general rule of law governing ordinary proceedings," but is based upon an actual agreement to subordinate the guarantee under the circumstances of the case, or (2) the circumstances that the issues arise in a state court prevents the bankruptcy court in adjudicating rights of participation under a Section 77B plan to apply the same rule of equity in bankruptcy proceedings. It is our position that neither of these possible bases of distinction is in fact applicable.

1. *The basis for the decision by the court below that the guarantor's holdings of the bond issue should be subordinated.* The decision of

the court below does not turn upon a finding of an actual agreement to subordinate. We invite the Court's attention particularly to that portion of the opinion of the Court of Appeals which, after reviewing the New York decisions and considering separate clauses in the certificate granting both forward an intention to subordinate and forward an intention to permit parity of treatment, concludes "when there is ambiguity in the agreement relied upon by the guarantee in support of a claim of parity, the rule drops away in the guarantee is subordinated" (italics supplied). * * * Under the settled course of decisions in this state the Trustees holdings are not entitled to parity. (R. 211)

The above quoted language indicates that the decision of the court below stands upon a principle of law so different from that which formed the basis of the earlier decisions of the Court of Appeals considered by this Court in the former cases. Those decisions were held to have established merely a general rule of law governing distribution in insolvency proceedings. We find no indication in the opinion of the court below that it disagrees with this Court's interpretation of the earlier New York cases or it interpreted that the state law as giving the public holders of the certificates any vested equitable right accruing to the insolvency proceedings which would have entitled them to insist upon subordination of the Trustees

holdings even had the issue been determined in the bankruptcy court.[5]

2. *The nature of the jurisdiction exercised by the state court under the plan.* The plan in pro-

[5] We have considered the possibility that the state law as revealed in this most recent decision of the Court of Appeals presents a different problem from the state law which was before the court in the *Geist* case in that there is now held to be as a matter of substatnive state law an equity in favor of subordination of the holdings of an insolvent guarantor which even a bankruptcy court would be bound to respect. Some basis for such a construction of the opinion below may be derived from the following language:

"The suits in the State court which are now before us are not proceedings in bankruptcy nor are they state liquidation proceedings. Each is brought to determine relative rights in property held for the satisfaction of a mortgage. Such rights, if not determined or defined by provisions of a plan of reorganization predicated upon the consents required by the Bankruptcy Act and approved by the bankruptcy judge as 'fair and equitable,' must be determined by the law of New York where the land is situated and where the bond and mortgage, the participation certificates and the agreement of guaranty were made and delivered. Accordingly, it becomes necessary for us to consider whether any provision of an approved plan of reorganization or any order of the bankruptcy court has determined or defined the relative rights of Prudence and other certificate holders to share in the security of the mortgage or in sums received on account of the mortgage debt. We find none in this record * * *." (R. 242-243).

Assuming that this language does place the New York law upon a different basis from that relied upon by this Court in the *Geist* case, there remains the question whether the issue is not inherently one as to relative rights of distribution in an insolvent estate and therefore subject to exclusive determination under the federal bankruptcy power. See the opinion of Frank, J., dissenting, in the *Geist* case in the Circuit Court of Appeals, 122 F. (2d) 503, 510.

viding for the determination of the issue of parity or subordination in a court of "competent jurisdiction" left open the question of whether the court of competent jurisdiction should be the bankruptcy court itself or some other court, state or federal. However, the fact that the reorganization proceeding was closed without any reservation of jurisdiction in the bankruptcy court, indicates a practical construction of the plan as intended to permit adjudication of the issue in some other court. In addition all parties to the action in the court below appear to have been in agreement that the New York Supreme Court is a court of "competent jurisdiction" within the meaning of the plan.

As an original question we would regard as erroneous the action of the reorganization court in failing to retain exclusive jurisdiction to determine an issue so close to the heart of what was "fair and equitable" in the circumstances. Nevertheless, since the plan did contain such a provision and the actions of the reorganization court in confirming such a plan and of terminating the proceeding without reserving exclusive jurisdiction to determine the issues are no longer subject to review, we do not think that any error on the part of the reorganization court would prevent the court below from exercising the jurisdiction which the parties acknowledged.

There remains the question of the nature of that jurisdiction. The plan clearly did not contemplate transferring the administration of the estate to any other forum, but purported merely to accelerate the termination of the bankruptcy administration by reserving for future determination as a legal, not an administrative, question the one substantial issue in dispute. Accordingly, both by the terms of the plan and by the pleadings, the action in the state court is an action for declaration of rights and not a proceeding for administration of the insolvent estate in the state court. As an action for declaration of rights arising under a plan of reorganization confirmed by the Section 77B court, it would seem to follow that the state court is bound by federal decisions defining and interpreting the rights to participate in the bankruptcy proceeding.

The opinion of the court below is in accordance with this analysis insofar as the Court of Appeals concluded that "the suits in the State court which are now before us are not proceedings in bankruptcy nor are they state liquidation proceedings" (R. 242). However, the court went on to decide that the failure of the bankruptcy court to take any action which might modify the relative rights in the property held for the satisfaction of the mortgage left the state court free to determine the question by the law of New York (R. 243). The Court of Appeals thereby construed the plan as involving not only a failure of the bankruptcy

court itself to determine whether subordination or parity might be found to be "fair and equitable", but as involving a far more questionable abdication by that court which would permit the issue to be decided in accordance with substantive standards which might be different from those which would be applicable in the bankruptcy proceeding itself. It is submitted that no such result could have been contemplated by the parties to reorganization or by the reorganization Judge in approving such a plan.[6] Under our construction of the plan, the state court in accepting jurisdiction to define the rights of the parties as created under the plan was accepting jurisdiction to determine an issue which the *Geist* case had held to be one of federal bankruptcy law, and therefore the correctness of its decision must be considered in the light of the applicable principles of federal law.

Despite what we conceive to be an error on the part of the court below in not treating the issue

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[6] Since the plan was adopted prior to the *Geist* case, it may be that there was then a difference of opinion as to whether the issue of parity or subordination should be regarded as an issue of state law or one of federal equity as administered in bankruptcy, but this question like the ultimate question must have been intended to be decided on a uniform basis regardless of the forum selected. It may be noted that if the Court of Appeals was correct in its holding, a federal court other than the bankruptcy court might likewise have been required under the doctrine of *Erie Railroad Co.* v. *Tompkins*, 304 U. S. 64, to decide the question in accordance with state law.

before it as one of federal law, we do not urge that the decision be set aside. For reasons set forth in the next section of the brief, we believe that the decision below should be affirmed because the facts were such as to require subordination of the guarantor's holdings under principles of equity which the *Geist* case recognized to be applicable in bankruptcy proceedings.

## II.

### THE DECISION OF THE COURT BELOW IS IN ACCORDANCE WITH THE PRINCIPLES OF EQUITY PROPERLY APPLICABLE, AS A MATTER OF FEDERAL LAW, TO THE STATUS OF CLAIMS PRESENTED BY A GUARANTOR IN A BANKRUPTCY REORGANIZATION PROCEEDING

While the Court of Appeals did not regard the *Geist* case as controlling, its decision is nevertheless in accordance with the principles of federal law expressed in that case. The *Geist* case in holding subordination improper on its own facts, nevertheless recognized that principles of suretyship law enunciated in cases involving solvent guarantors do as a general rule preclude the guarantor from participating on a parity with the holder of his guarantee. The facts presented in the *Geist* case were found to constitute an exception to that general rule on two grounds: First, it was held that no substantive considerations of equity warranted the subordination of the holdings of Prudence in the particular mortgage, since those interests had been acquired not as a subrogee or as an incident to its guarantee, but independently

of the guarantee. Second, the court held inapplicable the procedural consideration of avoiding circuity of action which might nonetheless have warranted subordination in the case of a solvent guarantor. In view of the guarantor's insolvency and the pending judicial reorganization proceedings, it was observed that subordination would have a substantive consequence upon the relative rights of the general creditors of Prudence and the holders of the guaranteed certificates. It is our position (1) that the facts of the present case warrant subordination upon substantive equitable grounds which the *Geist* case recognized to exist in the case of holdings acquired in connection with the guarantee, and (2) that this equity has a substantial practical basis both from the point of view of safeguarding the integrity of the guarantor's conduct in relation to the guarantee and from the standpoint of minimizing difficulties in the reorganization of guaranteed obligations.

1. With respect to the circumstances of acquisition, it may be noted that the *Geist* case dealt with guarantor's holdings constituting a relatively small percentage of the aggregate amount of the Zo-Gale issue involved in that case, consisting in large part of a residue of unsold participations in the mortgage, and, in part, of a small amount acquired as a bona fide investment when default was not anticipated. In the present case, however, the entire amount of the guarantor's holdings, constituting in the aggregate 42% of the

outstanding issue, was acquired after default on the Burnside issue and after Prudence had invoked the 18 months' grace period allowed for the payment of its guarantee. They were acquired as an incident to and in connection with the guarantee—in fact as a means of dealing with the more insistent holders of the guaranteed obligations, and in an effort to reduce its obligations as guarantor.

It had been the long established practice of Prudence to anticipate maturities of particular guaranteed issues by approaching certificate holders and attempting to sell them a new certificate of later maturity (R. 167–168, 169). As between Prudence and its customer, Prudence would thereby discharge its obligation as guarantor through the sale of a new guaranteed obligation. Under conditions prior to 1932 the customers understood, of course, that they might receive as an alternative the face amount of the old security. But with the advent of financial difficulties for the various real estate companies whose issues had been guaranteed, and for Prudence, a new element entered into the picture. Prudence had invoked the 18 months' grace period and was no longer prepared to discharge its guaranty at the maturity of the issue. At the same time Prudence undertook to effect settlements with its certificate holders on an individual basis by payments in cash where the certificate holder was clamoring

for cash, but usually at a discount; and by sale of a new certificate of later maturity when the customer could be induced to accept one; and by combination of cash payment and exchange for new certificates (R. 146, 157). There is testimony that a committee was set up to determine on the basis of individual need whether a particular customer would receive all or part of his claim in cash. However, the record of individual purchases shows gross discrimination in the basis for cash settlements at approximately the same time[7] and warrants the inference that examination into the needs of the customer served primarily as an index of the amount of the discount he might be willing to take for cash—or as to whether there might be other reasons for settling with the customer.

As in the pre-depression practice with respect to handling maturities, these transactions amounted in practical effect to a settlement and

[7] Examination of the details of acquisitions (R. 42–44) shows examples on the same day or within a few days where securities were repurchased in full at par, or repurchased in part at par or par plus interest, and in part exchanged for other certificates, while some securities were repurchased for cash at substantially below par. Cf. R. 43, Cert. 617, bought on July 7, 1932 at 52 flat with Certs. 385 and 482 bought on the same day for par flat and Certs. 433 and 796 bought for par flat on July 5 and 6. See also R. 42, Cert. 246, 184, and 123, on July 5 and 6, involving partial repurchases at par flat and partial reinvestments. Cf. Cert. 63 and 106 on July 8.

discharge of the guarantor's obligation rather than an investment in the outstanding certificates. The fact that the guarantor had invoked the grace period and that there was uncertainty as to whether it would ever meet the obligations in full made it possible for the guarantor to settle its obligations at a discount but did not change the character of the transaction as amounting in practical effect to the settlement of claims against it. Nor are the equities in favor of the guarantor's holdings enhanced by the fact that many of the purchases at a discount were made through a concealed brokerage account. With respect to all those transactions it could not be said, as this Court said in the *Geist* case, "they were acquired independently of its guaranty. They are not derived from or an incident to it."[8]

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[8] Prudence's activities in acquiring the certificates must be considered in the light of the provisions of the depositary and guaranty agreement under which the guarantor and its affiliate, Prudence-Bonds Corporation, virtually assumed the function of an indenture trustee for the certificate holders under an instrument carefully designed to give them the maximum of control over the mortgage although accompanied by sweeping exculpatory language purporting to minimize the responsibility of both the Depositary and the Prudence companies. Under the terms of the guaranty (R. 36) the guarantor corporation "is made irrevocably the agent" of the certificate holder "to collect the principal and interest as it falls due on said bond and mortgage aforesaid." The issuer of the certificates, Prudence-Bonds Corporation, stipulates in the certificate for similar collection rights on

2. Under the circumstances here present, the *Geist* case assumed that there would be an affirmative equity of subordination affecting the guarantor's holdings. Neither the *Geist* case nor the cases cited in the opinion articulate the basis for this assumption beyond intimating that it is in-

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behalf of itself or the guarantor, including the right "to take any action it may deem necessary or proper to protect the mortgage security and in its own name to enforce" the bond, mortgage, etc., and to "waive or modify" conditions in the bond or mortgage, including extending or waiving the payment of any installment of principal, provided only that the guarantor be not released (R. 33). Incorporated by reference in the certificate and made binding on the certificate holders is the depositary agreement between Prudence-Bonds Corporation and the Bank of America. That agreement is carefully defined to avoid assumption of any express trust by the bank, and while the depositary is given the sole right to protect the mortgage security and to enforce the bond and mortgage in the name of itself or of the certificate holders (Art. XVII, R. 27), it is not required to do so except upon written request of Prudence-Bonds Corporation or, if the certificates are in default, upon the written request of the holders of not less than 50% of the aggregate principal amount of the certificates then outstanding, and then only upon receiving satisfactory indemnity (Art. XIII, R. 24–25; Art. XIX, R. 28). Prudence-Bonds Corporation is made agent of the depositary to collect principal and interest on the mortgage and to disburse the same whether before or after default (Art. XXIII, R. 29–30).

Prudence's fiduciary position in this connection emphasizes the inequity of permitting it to prove on a parity those securities which it had purchased from its beneficiaries at substantial discounts in an effort to reduce and defer its own liabilities.

herent in the contractual obligations assumed by the guarantor.

Petitioner argues that any vice in these activities by which the guarantor's holdings were acquired was either in paying too much, in which case it is claimed that the general creditors of the guarantor and the remaining holders of the guaranteed creditors were equally prejudiced, or in paying too little, in which case any prejudice to those who sold out would only have redounded to the benefit of the remaining security holders by swelling the amount available in the guarantor's estate. If, however, the guarantor had shown greater respect for the integrity of its obligation and had undertaken to make payments pro rata on account of its guarantee to the extent of available funds, no question could have arisen as to the guarantor—or his estate—asserting any rights of subrogation against the individual real estate properties until after its guarantee had been discharged in full. Thus, unless subordination is enforced the remaining holders of the guaranteed obligations will have been prejudiced by the failure to make a pro rata payment in the attempt of the guarantor to escape full responsibility on its obligations.

Furthermore, to permit a guarantor, after default has occurred or is imminent, to acquire participations in the guaranteed issue with a view to proving them in competition with the public

security holders is to enable the guarantor to obtain a strategic position in any reorganization of the debtor, which may be used to harass and impede the realization of the claims of the public security holders against the debtor. Such acquisitions are thus in derogation of the guarantor's obligation.[9]

The dangers of permitting the guarantor to obtain such power over the reorganization of the debtor's estate flows from the inherent conflict between the interest of the guarantor to minimize its liability on its guarantee and the interest of those public security holders [redacted] the guaranteed issues. This conflict is the more insidious because it is not apparent to the average security holders, who may be misled into regarding any suggestions made by the guarantor in its capacity as a holder of the guaranteed issue as made solely with a view to obtaining the best possible treatment for the guaranteed issue. Such conflicts of interests may lead to action tending to delay the reorganization of the guaranteed issue where the guarantor happens to favor delay in the hope that time may lead

[9] Acquisition of strategic blocks of the guaranteed issue may even result in delaying efforts of the public security holders to compel action for the enforcement of their claims against the debtor. Thus Prudence's acquisition of 42% of the Burnside issue made virtually impossible the formation of any combination of public security holders sufficient to constitute the 50% of the outstanding issue which was necessary before the depositary could be required to take any action in connection with the enforcement of the mortgage.

to higher valuations than present circumstances would warrant. Such conflicts may also result in pressure for unrealistic reorganizations of the individual issuers involving extensive accounts of debt and other face value securities which may lend themselves more readily than would a more conservative security structure to arguments that the public security holders have received adequate satisfaction of their guaranteed claims. The courts in the reorganization proceedings might, of course, have power to mitigate or even frustrate the evils which flow from such a situation by their powers of classification and their powers to disqualify votes (see Section 216 of the Bankruptcy Act). But such powers are rarely successfully exercised and in practice the acquisition of a large block would give the guarantor a position which would frequently be effective in the settlement of those conflicts between claims mentioned in the preceding.

Another aspect of acquisition of guaranteed issues by the guarantor of a class of issuers is that the guarantor is likely to acquire the securities of the more aggressive of the junior holders of the guaranteed securities. Such persons, just because they are more aggressive and perhaps better informed than their fellow security holders, would be the potential leaders in any reorganization designed to obtain maximum recognition upon the guaranteed claims. To ignore the natural role of controlling which subordinates the

holdings of the guarantor will prevent such conflicts of interest from arising and tend to compensate the holders of the guaranteed claims for their failure to participate in the payments received by more alert guarantors.

Petitioner argues, however, that all such equities should be brushed aside in favor of parity of treatment for the sole reason that the guarantor is insolvent. Accepting this argument would not be following the terms now but going far beyond the holdings. In that connection it should be noted that creditors of the guarantor have outstanding the conflict of interest inherent in the structure holdings in the guaranteed bonds which are now held by the guarantor's estate. The estate is therefore interested in reducing the total amount of claims which might be asserted against it on behalf of holders of the guaranteed bonds and thus advised and confident with action which it might otherwise be prompted to take in furtherance of the reorganization of the guaranteed issue. We do not, of course, urge that such conflicts have in fact been operative in the Prudence reorganization. It is sufficient that the potentialities of any such conflicts of interest

Petitioner's arguments based on the fact that subordination may make for some fragmentation of [illegible] in the separate treatment of holders of the Riverside issue and other creditors of the guarantor, involving consideration of [illegible]

their influence upon the New York state courts where many guaranteed real estate issues have been reorganized. Considering the impact upon such creditors of the guarantor as are also holders of the various guaranteed issues, of a rule requiring subordination rather than parity of treatment, it may well make for more expeditious and practical reorganization to apply the rule of subordination. The consequence is that each class of certificate holders looks primarily to the separate estate of the mortgagor and is to that extent the less interested in realizing upon its claim against the guarantor's estate. The guarantor's estate in turn is less involved in the multitude of reorganizations of individual mortgage issues. In our judgment whatever element of fortuity there may be in applying the rule of subordination is outweighed by the prospects for more speedy realization which result from permitting each issue to be dealt with so far as possible as a separate reorganization.

There remains the problem as to whether the existence of general creditors' claims, such as that of the R. F. C. here, presents a special consideration in favor of parity of treatment with a view to swelling the participation of such general creditors in the guarantor's estate. In that connection it should be noted that we are here dealing with the unpaid balance of what was formerly a secured claim, which must therefore rest only on the general credit of the guarantor.

It is our view that persons extending general credit to a company engaged in such a type of business, involving as it does complex fiduciary relationships to the many holders of its guaranteed issues, should be held to have made their loans subject to the risk of any equities of subordination which should apply as between Prudence and the holders of the guarantees. Their situation in that respect is not unlike that of creditors of a holding company who necessarily take the risk of equities of subordination in the holding company's dealings with its subsidiaries. See *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307.

## CONCLUSION

It is submitted that the decision of the court below should be affirmed as in accordance with the principles of equity properly applicable as a matter of federal law to rights of participation in a bankruptcy reorganization.

Respectfully submitted.

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I have authorized the filing of this brief.

CHARLES FAHY,
*Solicitor General.*

DECEMBER 1944.

U. S. GOVERNMENT PRINTING OFFICE: 1944

# SUPREME COURT OF THE UNITED STATES.

No. 137.—October Term, 1944.

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| Prudence Realization Corporation, Petitioner, *vs.* Joseph W. Ferris, et al., Respondents. | On Writ of Certiorari to the Supreme Court of the State of New York. |

[January 29, 1945.]

Mr. Justice Frankfurter delivered the opinion of the Court.

This action was brought in one of the courts of the State of New York to adjudicate conflicting claims against property held to satisfy a mortgage debt. The immediate controversy arises out of the reorganization in a United States district court of a large New York guaranty company, another phase of which was before us in *Prudence Corp.* v. *Geist*, 316 U. S. 89.

Petitioner's predecessor, The Prudence Company, Inc., loaned money on real estate and issued guaranteed mortgage participation certificates. (For an exposition of the business details see *In re The Westover Inc.*, 82 F. 2d 177.) The enterprise was on a vast scale, running into the hundreds of millions. Our immediate concern is with certificates of participation issued by Prudence in a bond and mortgage made by Burnside Improvement Company. Prudence guaranteed the certificate holders the payment of interest and principal when due or within eighteen months thereafter. Burnside, the mortgagor, defaulted in the payment of an instalment of principal due January, 1932. After this default, Prudence itself purchased, either directly from the holders or through a concealed brokerage account and usually at a discount, certificates aggregating $431,212.86, approximately 42% of the amount of outstanding certificates. In June, 1932, the mortgaged premises securing the Burnside certificates were conveyed to Amalgamated Properties, Inc., a wholly-owned subsidiary of Prudence.

In 1935 Prudence went into reorganization under § 77 B of the Bankruptcy Act, and was adjudicated insolvent in 1938. As part of the Prudence proceedings, Amalgamated, in 1936, filed a

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voluntary petition for reorganization, but the two were later severed. Thereafter, under a reorganization plan confirmed by the District Court, all the assets of Prudence, including the Burnside certificates reacquired by it, were transferred to petitioner, Prudence Realization Corporation.

In the Amalgamated proceeding Prudence claimed to participate in the mortgage on a parity with other Burnside certificate holders. The claim was opposed on the ground that Prudence, having defaulted on its guaranty, was not entitled to parity with other holders of certificates. The bankruptcy court neither decided this question of parity nor reserved it for decision. It "terminated and finally closed" the Amalgamated proceeding by confirming a plan which left the claim of participation by Prudence in the Burnside bond and mortgage for adjudication by a "Court of competent jurisdiction". There were provisions, with which we are not here concerned, for holding in escrow, pending such an adjudication, the share claimed by petitioner.

Thereafter, respondents, the trustees under the Burnside plan, and various certificate holders brought this action in the New York Supreme Court to determine petitioner's right to participate as holder of certificates acquired by the insolvent guarantor. Petitioner's claim for parity of treatment was denied, but this denial was reversed by the Appellate Division, 266 App. Div. 543, which in turn was reversed by the Court of Appeals. It held that state law governed and that New York subordinated the guarantor's certificates. 292 N. Y. 210. We brought the case here, 323 U. S. —, because conflict with *Prudence Corp.* v. *Geist, supra,* was strongly pressed. Precise appreciation is therefore required of the record now before us compared with that on which the *Geist* decision was based.

In the *Geist* case, the claim of parity by the same petitioner arose in connection with different property and another certificate issue, the Zo-Gale issue. In that case also the question of parity was not settled in the order of confirmation. But, while it was reserved for a court of competent jurisdiction, the confirmation order clearly indicated that the bankruptcy court was reserving jurisdiction in itself. "The court retains jurisdiction to hear and determine all questions arising under paragraph 7 of this order" —so ran the terms of the reservation of the parity question in the *Geist* case—and the trustees "are hereby granted leave to apply at any time at the foot of this order for such adjudication." The

trustee, Geist, accordingly applied to the bankruptcy court for an order adjudicating the rights of the certificate holders and that court, "In the Matter of a Plan of Reorganization of Amalgamated Properties, Inc., Debtor, in Respect of the Zo-Gale First Mortgage Participation Certificates" issued an order to show cause. When the Amalgamated proceeding with respect to the Zo-Gale property was subsequently closed, the order provided that "these proceedings shall hereafter be treated as dismissed for all purposes, except the determination of the questions raised in the pending motion by A. Geist . . . for determination of the relative priorities . . ." The bankruptcy court had patently retained for decision the question affecting the distribution of the bankrupt's property, although in all other respects it had wound up the proceedings. "The bankruptcy act prescribes its own criteria for distribution to creditors . . . . The court of bankruptcy is a court of equity to which the judicial administration of the bankrupt's estate is committed. . . . and it is for that court—not without appropriate regard for rights acquired under rules of state law—to define and apply federal law in determining the extent to which the inequitable conduct of a claimant in acquiring or asserting his claim in bankruptcy requires its subordination to other claims which, in other respects, are of the same class." *Prudence Corp.* v. *Geist*, *supra* at 95. Accordingly we held that the district court, sitting as a bankruptcy court, was under duty to apply federal and not state law, and that, in the circumstances of the *Geist* case, there was "no agreement and no equitable basis for depriving the Prudence Company and its creditors of the benefits of the usual bankruptcy rule of equality". *Prudence Corp.* v. *Geist*, *supra* at 97.

This case is not the *Geist* case. Here the bankruptcy court neither considered the question of parity nor retained jurisdiction to consider it. The order of confirmation contained no provision for retention of jurisdiction to decide the parity question as did the *Geist* order. Nor did the closing of the reorganization reserve jurisdiction, as did the *Geist* closing order. The provisions for disposition of the impounded funds in case subordination be determined are much more elaborate than the *Geist* case discloses. In short, while the provisions for adjudication of the parity question in the *Geist* case clearly contemplated determination of it as part of the reorganization proceedings by the bankruptcy court itself, in

the present case the bankruptcy court washed its hands of the problem and left the parties to litigate the question in another forum. For it is not questioned that the state court was a "Court of competent jurisdiction" for adjudicating the claim of parity.

To be sure, the Securities and Exchange Commission, as *amicus curiae*, suggests that the bankruptcy court was in error in failing to retain jurisdiction for determining this aspect of distribution. But the different treatment of the same problem by the same court in the *Geist* case and in this, together with acquiescence by the petitioner in the closing order without seeking a review of the nonretention of jurisdiction, give ground for believing that the arrangement was the product of bargaining between the parties. In any event, since no appeal was taken, it is not now open to find error by the bankruptcy court in failing to retain jurisdiction. The order confirming the plan of reorganization is res judicata, *Chicot County Dist.* v. *Bank*, 308 U. S. 371, 378.

But it is urged that although the bankruptcy court specifically refused to consider the rights of the parties and remitted them, plainly enough, to the state courts for their determination, the rights were to be determined in the state courts by federal law because the parties had passed through federal reorganization proceedings. In spite of an order of final termination, the authority of the bankruptcy court somehow continues to be effective. Despite the fact that neither the bankruptcy court nor the reorganization statute professes to alter rights unless disclosed in the plan or in an order, we are asked to recognize some enveloping cloud of amenability to the law governing bankruptcy proceedings.

We find no warrant in the statute for so holding. Section 77 B, [redacted] under which this reorganization was accomplished, provides in subsection (g) that upon confirmation "the provisions of the plan and of the order of confirmation shall be binding". The rights are thus fixed as the plan and the order provide and are not otherwise affected. Subsection (h) provides that upon final confirmation the debtor or its successor corporation "shall put into effect and carry out the plan and the orders of the judge relative thereto . . . and the property dealt with by the plan . . . shall be free and clear of all claims of the debtor, its stockholders and creditors, except such as may consistently with the provisions of the plan be reserved in the order confirming the plan . . . ". The final decree, discharging the trustees and closing the case,

"shall discharge the debtor from its debts and liabilities, and shall terminate and end all rights and interests of its stockholders, except as provided in the plan or as may be reserved as aforesaid." Here the court entered appropriate orders to secure the execution of the plan and the termination of the proceedings. But the relative priority of participation was passed upon neither in the plan nor by the court. Instead, it was specifically reserved. And it was reserved for determination, as the parties saw fit to have it determined, by the New York courts without restriction by the federal adjudication. The parties were out of the federal bankruptcy court with their original rights modified by the terms of the reorganization plan. When they came before a New York court seeking a determination of their present rights, that court was obliged to ascertain whether any rights had been fixed by the reorganization plan and, if so, to enforce them. Rights not affected by the federal proceedings the New York court was free to decide according to New York law. The bankruptcy court had refused to fix the rights of the parties as to the participation of Prudence-owned Burnside participations, and expressly left them to be fixed by the New York court as a "Court of competent jurisdiction". Accordingly, it was for the New York Court of Appeals to define the governing New York law.

And since, in the circumstances of this case, New York law governs, we are not called upon to indicate, it hardly needs to be added, whether the result would be different were the federal rule for distribution to creditors applicable.

*Affirmed.*

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Mr. Chief Justice STONE.

I concur in the result.

The relative priority of Prudence's participation in the bankrupt's estate in a 77 B reorganization is a federal right governed by federal not state law. *Prudence Corporation* v. *Geist*, 316 U. S. 89, 95. As the reorganization plan did not purport to alter that right, but merely provided that it should be determined by a court of "competent jurisdiction", I cannot conclude that the adoption of the plan contemplated or effected the alteration of the federal right by requiring it to be redefined in terms of the law of New York, or of any other jurisdiction, where the parties might happen to seek its adjudication.

The fact that a federal right is to be ascertained in a state rather than in a federal court does not make it any less the duty of the court to apply federal law. *Chesapeake & Ohio Ry. Co.* v. *Martin*, 283 U. S. 209, 212-213; *Awotin* v. *Atlas Exchange Bank*, 295 U. S. 209; *Brady* v. *Southern Ry. Co.*, 320 U. S. 476, 479, and cases cited; *Illinois Steel Co.* v. *Baltimore & Ohio R. R. Co.*, 320 U. S. 508, 511, and cases cited; *Steele* v. *Louisville & Nashville R. R. Co.*, No. 45, decided December 18, 1944, p. 9 of slip opinion. And a mere grant by the federal court of permission to the parties to litigate a federal question in a state court, is not a direction that the question be determined by state law, more than is a general statutory authorization for a suit in the state court on a federal right.

The state court has held that petitioner, the holder of mortgage participation certificates, is not entitled to share in the mortgage until the holders of other certificates, which petitioner has guaranteed, are paid in full. Its judgment should be affirmed, not because the plan called for determination of petitioner's rights in the bankrupt's estate by state rather than federal law, but because in the circumstances of this case the applicable federal law is the same as that which the state court has applied. Petitioner did not, as in the *Geist* case, acquire its interest in the mortgage as an original investment before it sold and guaranteed certificated shares in the mortgage, nor did it acquire its own certificates independently of the performance of its obligation as a guarantor of the certificates. Petitioner is here in the position of a subrogee of a claim whose payment it has guaranteed. For it acquired its claim to participate in the mortgage through performance of its guaranty, by purchase, after default, of the certificates of participation which it had guaranteed.

As we recognized in the *Geist* case, and were at pains to point out, 316 U. S., at p. 96, such a case is within the rule of *United States* v. *National Surety Co.*, 254 U. S. 73, 76; *Jenkins* v. *National Surety Co.*, 277 U. S. 258; *American Surety Co.* v. *Electric Co.*, 296 U. S. 133, "that a solvent guarantor or surety of an insolvent's obligation will not be permitted, either by taking indemnity from his principal or by virtue of his right of subrogation, to compete with other creditors payment of whose claims he has undertaken to assure, until they are paid in full."

Mr. Justice RUTLEDGE concurs in this opinion.